

## Sunil Mendis: Basel II - preparation of implementation in the Asia-Pacific region

Keynote address by Mr Sunil Mendis, Governor of the Central Bank of Sri Lanka, at the SEACEN Seminar on Basel II: Preparation of Implementation in the Asia-Pacific Region, Colombo, 7-10 December 2005.

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Dr Subarjo, Executive Director of the SEACEN Centre, Deputy Governors and Distinguished Guests,

Thank you for the invitation to speak at this SEACEN Conference of Bank Supervisors and industry participants in the Asia Pacific Region, on a topic that is currently occupying centre stage in the regulatory arena – the implementation of Basel II and its challenges.

Basle II has been the major preoccupation of bank regulators all over the world for the last seven years. This seminar is of particular significance as it brings together regulators and industry participants to a common arena to share experiences and challenges in the operational and policy issues involved in the implementation of this new capital accord. I am particularly happy because this first ever seminar bringing together the industry participants in a SEACEN programme on this important subject was a result of a suggestion made by me at the last SEACEN Governors' Conference held in Fiji earlier this year and that it is held in my own country. Its implementation is seen as one of the most significant challenges facing the banking industry the world over, in recent times.

Unlike Basel I, which was simple and user friendly, Basel II is complex. Therefore, the Basle Committee has quite rightly advised that regulators and banks should approach it with caution even with regard to the simplest approach to Basel II. We commenced our journey one year ago, together with the industry, and we will move slowly, but steadily, towards full implementation of the basic approach, hopefully in 2008. We will, however commence our test runs in parallel with Basle I in 2006, fine tuning our systems for full compliance as we go along. This would be in line with the widely accepted policy that countries should adopt the options and approaches that are most appropriate for the state of their markets, their banking systems, and their supervisory structures.

In Sri Lanka, as in most countries, the banking sector enjoys predominance in our financial system. As is to be expected, the financial environment, domestically, is becoming more innovative and competitive to meet the sophistication of peer foreign banks and the needs of investors and consumers. This naturally increases their risk profile. Increasingly, therefore, our remit as regulators is to ensure an efficient risk management framework and the adequacy of resources to mitigate risk. Against this background, therefore, Basle II is synonymous with good risk management, not only of the core risk of credit default, but of a wider range of risks such as market risk and operational risk in Pillar I. Together with the mutually reinforcing pillars II and III, of regulatory review and market discipline, Basle II represents a formidable tool to insulate banks against inherent risks in the highly leveraged business of banking.

In this process, we must be mindful of the fact that Basle II has been built on the experiences and risk parameters of developed, sophisticated economies. Through customization to suit conditions and markets in emerging economies, which have fundamentally different characteristics, the principles of Basel II should be appropriately adapted to suit such conditions. The "one size fits all" solution of Basle I will not suit the complexities of Basle II. The markets in which we operate have their own peculiarities and their own cultures. Promoting international best practice in such a culture is, indeed, a challenge which demands a fundamental change in credit cultures, attitudes, and policies. The will to change is important and in the case of banking institutions, has to be mandated, if it is to be in the best interests of the major stakeholders, the depositors.

Full implementation of Basel II is, indeed, demanding for banking institutions and regulators alike. Capacity building is an imperative on both sides, as is the framework for good risk management built on risk models. The supervisory capacity to assess and validate these models must be enhanced and developed. The magnitude of the investment in technology by the banks must be justified in a business sense. We must ensure that the cost of compliance does not outweigh the benefits from Basle II. Emerging market economies are very vulnerable to the reputational risk of non-compliance. Therefore we must take one step at a time. The infrastructure for compliance - legal, accounting and market - must be established and is an essential pre-requisite which underlies the success of these initiatives.

The implications on the several sub sectors of our economy from Basle II will have to be examined carefully with regard to access to finance and the pricing of risk. Uneven playing fields may arise as a result of the internationally active foreign banks adopting more advanced approaches, thereby improving their competitiveness over their local counterparts. Will the models developed by the foreign banks be relevant for the risks in our markets? These are the regulatory challenges which have to be addressed by the regulators.

In meeting these challenges, the local banks must make best use of the existing resources to minimize the cost of full compliance. They can build on their existing data bases and leverage on the default data available in institutions such as the Credit Information Bureau. They can benefit from data pooling within the industry. All these resources must be harnessed.

It is important that the banks do not lose sight of the long term benefits of Basle II of better capital allocation and consequently, better pricing, because they are embroiled in the details necessary to meet the deadline. The ultimate objective is financial stability. I am sure that this dialogue that we have initiated today will result in a fruitful exchange of views on this important subject and will help to consolidate our implementation plans on this long journey that we have all commenced.

I therefore wish you all a very stimulating and useful discussion and a very successful seminar.

Thank you.